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SENSITIVE
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TAGS: ECON EFIN ETRD EAGR ENRG PREL PGOV PK
SUBJECT: PAKISTAN'S 2008-2009 BUDGET: OVERLY OPTIMISTIC, PART ONE OF THREE

SUMMARY
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¶1. (SBU) The Government of Pakistan (GOP) released its USD 31 billion 2009-2009 budget June 11 in a speech by Finance Minister Naveed Qamar to Parliament. In addition to setting revenue targets and expenditure levels, Pakistan's budget also includes assumptions on economic growth and economic policy measures. This message is part one of a three part series detailing Pakistan's 2008-2009 budget. Part two will cover energy measures, while part three will cover agricultural sector reform and poverty alleviation programs. The current fiscal year's budget set an overly optimistic growth figure of 5.5 percent, with annual inflation running at 12 percent. The GOP will reduce the fiscal deficit from nine to 4.7 percent of GDP. Imposition of additional taxes will increase revenue collection by 25 percent to USD 1.85 billion.

¶2. (SBU) Summary continued: Proposals for the phase out of energy subsidies by December 2008 have been discussed. Resumption of the privatization program, decreases in subsidies and increased duties on luxury goods are expected to decrease the current account deficit from seven to six percent of GDP. Reserves are targeted to increase to USD 12 billion. Given the downturn in Pakistan's economy, this budget seems overly optimistic in terms of growth, revenue collection and closing the fiscal and current account deficits. Qamar introduced a proposal for new government bonds with market interest rate yields to decrease borrowing from the State Bank of Pakistan. No increase in the military budget reflects a real decrease in spending because of inflation. For the first time, it is more than a single line item, but is still opaque.

¶3. (SBU) Summary continued: Energy was given special mention, with plans to promote unrealistic conservation and efficiency measures to reduce demand by 1500 MW to decrease the electricity shortfall to 3000 MW. Qamar also proposed an increase in the minimum wage from USD 59.12 to USD 88.69, a pension program, a 20 percent increase in government salaries and increases for poverty alleviation programs (septel, part three). End summary.

"UNFAVORABLE DEVELOPMENTS" MEAN MISSED TARGETS
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¶4. (U) Pakistan's Finance Minister Naveed Qamar gave the annual speech to Parliament rolling out the USD 31 billion FY 2008-2009

budget June 11. (Note: Pakistan's fiscal year runs from July 1 - June 30 the following year. According to Pakistan's Constitution, the budget must be debated and passed by Parliament before the July 1 beginning of the fiscal year. End note.) He first gave an overview of the "unfavorable developments" during the current fiscal year. As a result of increases in international commodity prices and the previous government's unwillingness to curtail spending, Qamar commented that Pakistan missed its fiscal and monetary targets for FY 2007-2008. Growth was 5.8 percent, compared to the 7.2 percent target and 6.8 percent growth rate during the previous fiscal year. The missed growth target is largely due to weak growth in the manufacturing and agricultural sectors. Inflation was 11 percent, as compared to 7.8 percent during last fiscal year.

¶5. (U) The budget deficit will be a record seven percent of GDP, compared to the four percent target. The current account deficit is projected at USD 11 billion, or seven percent of GDP. Reserves declined from a record high of USD 16.5 billion to less than USD 12.3 billion at the end of April 2008. The rupee depreciated nearly 6.4 percent between July 2007 and April 2008. Qamar highlighted that the deficit was financed through borrowing from the State Bank of Pakistan (SBP), "which is like printing money." He made the link between SBP borrowing and inflation, adding that "we have to stop this process; otherwise, inflation will be much higher than it is at present."

BUDGET AMBITIOUS AND TARGETS OPTIMISTIC
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¶6. (U) The GOP established six priorities for the 2008-2009 budget:

-- restore economic stability through reduction of the fiscal and current account subsidies, "rationalization of subsidies," and accumulation of foreign exchange reserves;
-- protect Pakistan's most vulnerable sectors of society;
-- increase social sector spending to improve social indicators;
-- improve housing for the most disadvantaged Pakistanis;
-- increase the productivity of the agricultural and manufacturing sectors; and
-- restore investor confidence by emphasizing the government's commitment to economic growth, investment, and the key role of the private sector.

Part three of this message (septel) will look at the agricultural sector and poverty alleviation measures included in the proposed budget.

¶7. (U) The GOP has also set ambitious macroeconomic targets for the FY 2008-2008 fiscal year, including:

-- 5.5 percent GDP growth;
-- 12 percent inflation;
-- 25 percent investment to GDP ratio;
-- reducing the fiscal deficit from 7.0 to 4.7 percent of GDP;
-- reducing the current account deficit from seven to six percent of GDP; and
-- increasing the foreign exchange reserves to USD 12 billion.

PHASING OUT ENERGY AND ELECTRICITY SUBSIDIES
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¶8. (SBU) Qamar mentioned phasing out subsidies in very general terms in his budget speech, saying many of the subsidies benefit "groups that are neither needy nor should be subsidized." He added that "a detailed pruning of subsidies is necessary and inevitable to preserve the country's finances." While not included in the budget speech, the Ministry of Finance (MOF) proposed to the Federal Cabinet that consumer fuel prices should be at parity with international prices by December 30, 2008. The MOF also proposed that consumer fuel prices be adjusted periodically in accordance with fluctuations in international fuel prices. (Comment: Phasing out subsidies by the end of the year would require nearly tripling prices at the pump, which is unlikely to happen. See part three of

this message for more details. End comment.)

¶9. (SBU) The MOF also seeks to roll back electricity subsidies and has proposed to the Cabinet that the GOP allow for fluctuations in the fuel surcharges to cope with international prices. MOF also proposed amending the tariffs set by the National Electric Power Regulatory Authority (NEPRA) to allow additional fuel surcharges or other taxes on per unit electricity consumption with an aim of eliminating subsidies to the power sector by the end of 2008.

LIMITING BORROWING FROM THE CENTRAL BANK
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¶10. (U) Qamar was adamant in his presentation that the GOP must limit borrowing from the State Bank of Pakistan (SBP), commenting that "borrowings from the central bank have reached an unacceptable level. This is a major source of inflationary pressures and should be contained." The MOF has proposed a series of three, six and 12 month bonds which will be available from authorized commercial banks and will yield market interest rates. New products will also be introduced as part of the National Savings Scheme.

NEW TAXATION MEASURES
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¶11. (U) In order to close the fiscal deficit, the GOP has formulated a set of new taxes, which it believes will boost tax revenues by 25 percent to USD 1.85 billion. The GOP will attempt to reduce its reliance on indirect taxes. Direct taxes now account for 39 percent of tax collection. The GOP proposes to increase duties on 300

non-essential and luxury items from the 15 to 25 percent range to between 30 and 35 percent. These items include cosmetics, many domestic appliances, luxury food items and cigarettes. The custom duties on cars with 1800cc and larger engines will be raised from 90 to 100 percent. A five percent duty will be imposed on imported vehicles with engines smaller than 850cc. A USD 3.70 duty will be assessed on imported cell phone handsets.

¶12. (U) The GOP will also raise the general sales tax from 15 to 16 percent, and increase the excise tax on telecommunications services from 15 to 21 percent. Excise taxes on banking and insurance services will be raised from five to ten percent. Excise taxes on cement will be increased from USD 11.08 per metric ton to USD 14.04.

¶13. (U) Qamar acknowledged that, while the number of Pakistanis paying taxes had increased to 20 percent of the population, that figure is still low given Pakistan's population of 160 million. Pakistan's tax to GDP ratio still remains one of the lowest in the region at 11 percent. He proposed the withdrawal of 11 income tax exemptions, but increased the overall income tax exemption to USD 2,665 for men and USD 3,548 for women.

INDUSTRY AND MANUFACTURING
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¶14. (U) Qamar proposed a number of measures aimed at shoring up Pakistan's industrial competitiveness, including an increase on duties from five to 20 percent on imported sewing machines; and decreasing import duties on raw materials for a wide range of industries, including textiles, pharmaceuticals and call centers. The MOF also proposed a number of modest measures to benefit foreign investors. These include the elimination of local offsets for the import of capital goods worth more than USD 50 million for the establishment of new industrial projects.

MILITARY BUDGET
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¶15. (U) The military budget was not mentioned in the Finance Minister's speech. However, Prime Minister Gilani announced earlier in the week that there would be no increases in this year's military budget. This implies a real decrease of around six percent, after accounting for inflation and rupee depreciation, according to

Ministry of Finance contacts. For the first time, the 2008-2009 budget documents provide a breakdown between defense administration and military defense. Military defense is further broken down into employee-related expenses, operating expenses, physical assets, civil works and an undefined "less recoveries" category. Total military spending for the 2008-2009 fiscal year is USD 4.38 billion. (Comment: Between Coalition Support Fund reimbursements, Foreign Military Sales and a few smaller programs, the U.S. contributes approximately 25 percent of Pakistan's stated defense budget. Pakistan's strategic weapons budget is not publicly available. End comment.)

COMMENT
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¶16. (SBU) Comment: The Ministry of Finance's proposed budget is overly optimistic on growth, revenue, deficit reduction, expenditure targets as well as the elimination of subsidies. It is heavy on poverty alleviation measures (part three of this message), consistent with the electoral promises of both the Pakistan Peoples Party (PPP) and the Pakistan Muslim League - Nawaz (PML-N). However, it falls considerably short of recommending any meaningful measures that will address Pakistan's increasingly severe energy crisis (part two of this message). This is only the MOF's proposal; Parliament will now debate it before passage in advance of the July 1 beginning of the fiscal year. End Comment.

PATTERSON